FILE COPY

Office-Supreme Court, U.S.
FILED
SEP 4 1959
JAMES R. BROWNING, Clerk

No. 373

Supreme Court of the United States

October Term, 1959

LLOYD U. NOLAND, JR., AND
JANE K. NOLAND,

Petitioners,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Respondent

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

---

GEORGE D. GIBSON
H. BRICE GRAVES
GEORGE C. FREEMAN, JR.
1003 Electric Building
Richmond 12, Virginia
Counsel for Petitioners

HUNTON, WILLIAMS, GAY,
MOORE & POWELL
Of Counsel

Dated September 4, 1959

TABLE OF CONTENTS

	Page
Opinions Below	1
Jurisdiction	1
Question Presented	1
Statute Involved	2
Statement of the Case	2
Reasons for Granting the Writ	6
1. There Is a Conflict Between the Circuits on the Question in Issue	6
2. The Question Is of Importance to the Proper Administration of the Revenue Laws	11
Conclusion	13

Appendix:

Opinion of the Tax Court	App. 1
Opinion of the United States Court of Appeals for the Fourth Circuit	App. 13
Opinion of the United States Court of Appeals for the Second Circuit in *Schmidlapp* v. *Commissioner*, 96 F. 2d 680 (1938)	App. 21

TABLE OF CITATIONS

Cases

	Page
Benjamin Abraham, 9 T. C. 222 (1947)	7
Cohan v. *Commissioner*, 39 F. 2d 540 (2nd Cir. 1930)	8
Harold A. Christensen, 17 T. C. 1456 (1952)	7, 11
Deputy v. *DuPont*, 308 U. S. 488 (1940)	6
Embry's Estate v. *Gray*, 143 F. Supp. 603 (W. D. Ky. 1956)	8, 10
Gray v. *Embry's Estate*, 244 F. 2d 718 (6 Cir. 1957)	8, 11
Hill v. *Commissioner*, 181 F. 2d 906 (4th Cir. 1950)	9
Schmidlapp v. *Commissioner*, 96 F. 2d 680 (2nd Cir. 1938)	7, 8, 9, 10, 11

Statutes

Internal Revenue Code of 1939, Section 23(a)(1)(A)	1, 2, 11
Internal Revenue Code of 1954, Section 162(a)	1
United States Code, Title 28, Section 1254(1)	1

Other Authority

Note, *Deductibility of Expenses Incurred for the Benefit of Another*, 66 Harv. L. Rev. 1508 (1953)	8

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Lloyd W. Noland, Jr., and Jane K. Noland, respectfully pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Fourth Circuit, entered in this case on June 10, 1959.

OPINIONS BELOW

The opinion of the Tax Court is not reported officially[1] but is printed in the Appendix at page 1.

The opinion of the Court of Appeals is not yet reported but is printed in the Appendix at page 13.

JURISDICTION

The judgment of the Court of Appeals was entered on June 10, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

The taxpayer, in the course of earning his living as an officer of a corporation, incurred an expense that benefited both himself and the corporation. Normally it would have been allowed to him as a business deduction under § 23(a)(1)(A) of the Internal Revenue Code of 1939,[2] since the business nature of the purpose is undisputed. Should it

---

[1] Unofficially reported by Commerce Clearing House, Inc., at 17 T.C.M. 301 (Apr. 14, 1958).

[2] Section 162(a) of The Internal Revenue Code of 1954.

nevertheless be disallowed as a matter of law on the ground that the corporation also benefited and that as a "dominant officer and stockholder" he could have caused the corporation to reverse its customary policy or make an exception from it and reimburse him for the expense?

STATUTE INVOLVED

Section 23 of the Internal Revenue Code of 1939:

> "In computing net income there shall be allowed as deductions:
>
> "(a) Expenses.—
>
> (1) Trade or Business Expenses.—
>
> (A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business . . . ."

STATEMENT OF THE CASE

This is a suit to correct alleged deficiencies in Federal income taxes for the years 1952 and 1953. Separate cases for the two years were instituted by the taxpayer in the Tax Court, and then consolidated. They were tried before Judge Stephen F. Rice. The taxpayer called two witnesses; the Commissioner called none. After hearing and the submission of briefs, the trial judge died. Judge John E. Mulroney was assigned to the case. Neither party requested hearings and Judge Mulroney thereafter ruled in favor of the Commissioner. On appeal, the Court of Appeals sustained the holding of the Tax Court.

The facts are not in dispute and may be summarized as follows:

Lloyd Noland (the taxpayer) and his wife filed joint income tax returns for the calendar years 1952 and 1953.

During those years the taxpayer was the President and a director of Noland Company, Incorporated, a Virginia corporation, having been elected President the year before. During this year, the taxpayer also was chief executive officer of a number of other corporations (A. 30, 79). But the greater part of the deductions taken were for expenses incurred in earning compensation as President of Noland Company, Incorporated (the Company).

The Company is a wholesale distributor of plumbing, heating, industrial and electrical supplies and machine tools (A. 19). It has 34 branch operating units located throughout the southeastern United States (A. 19) and employs about 1,200 people (A. 35). From its founding some 40 years ago by the taxpayer's father, the Company has followed a policy of paying bonuses to its key employees based on Company net profits. The bonus aggregates 25% of its annual net income before taxes and during each year since World War II has usually exceeded $1,000,000 (A. 20, 32, 33). The bonus of an employee is often larger than his fixed salary, especially at the upper levels of management, and is given to encourage the officers and other employees to feel an individual incentive and responsibility (A. 77). As part of this philosophy the officers have been expected to absorb various promotional expenses out of their own pocket without seeking reimbursement from the Company (A. 20), in contrast to routine disbursements, like travel expenses, which are reimbursed. In general, management personnel have been expected to pay:

(a) the expenses of entertaining customers and potential customers or others, such as contractors, architects and engineers, who are in a position to place orders with the Company (A. 22) and

(b) expenditures designed to build up goodwill for

the Company, with the public or Company personnel (A. 22).

The bonus received by the taxpayer has been a material part of his compensation from the Company, as the following table indicates (A. 77, 78):

Lloyd U. Noland, Jr.
Salary and Bonus Received from the Company

	1949	1950	1951	1952	1953
Salary	$ 6,000	$ 6,000	$ 9,961	$12,230	$25,480
Bonus	11,000	8,500	16,900	30,000	15,000
Total	$17,000	$14,500	$26,861	$42,230	$40,480

For many years the Company gave a party at Christmas in the head office at Newport News. Originally it had been for customers of the Company, but gradually it changed to a party for the Newport News employees (A. 33, 34). It was not, however, proving successful as a party, primarily because of the location. To remedy this deficiency, the taxpayer concluded in 1951 that the right kind of a Christmas party given by him personally in other surroundings would help him become a more effective President of the Company by developing a closer personal relationship with the head office employees who constitute his staff in carrying out his policies (A. 34). He was also aware that this would be a factor in increasing his personal compensation through the bonus plan.

So beginning with the year 1951 (A. 34) and continuing through the taxable years here in question the taxpayer gave a Christmas party for the office employees of the Company in Newport News and their wives or husbands (A. 35). Each was held at the Chamberlin Hotel, near Newport News. The cost of the 1952 Christmas party was $3,965.50. The cost

of the 1953 Christmas party was $3,658.50. (A. 46, 49, 74, 77).

Since these expenditures were promotional rather than routine, they came within the non-reimbursement policy of the Company. They were thus a part of the cost to the taxpayer of earning his compensation as President of the Company (A. 23) and he sought no reimbursement for them.

There is no suggestion that this was pure fun for the host. Entertaining his staff was a step of business leadership. But the court below concluded that since the Company also benefited, the taxpayer was precluded as a matter of law from taking the deduction. This introduces a novel and noxious principle into one of the most important provisions of the tax law. Denying an individual any deductions for plain business purposes on the mere ground that they also benefit the business of the corporation will tend to undermine individual initiative and responsibility among the officers and employees of corporations.

Of less general importance were a number of other contributions, likewise denied below. For example, the taxpayer contributed $1,500 to the Peninsula Industrial Committee, of which he was chairman, during the 1953 fund raising campaign. This was a personal contribution, in addition to contributions by the Company and other corporations with which the taxpayer is connected (A. 52). He considered his relationship to the fund and his contribution to it to be helpful to him in his capacity as President of the Company (A. 52).

These additional items, if they stood alone, would not merit review by this Court. They are mentioned, however, to put the issue in context and to point out that there is no question here of petitioners' exceeding the aggregate limits of usual and reasonable deductions, as is apparent from the following table:

	1952	1953
Adjusted Gross Income	$299,243.79	$263,523.34
Total Deductions	25,149.57	30,841.45
Net Income	274,094.22	232,681.89
Income Tax	206,036.80	168,765.58

This is also apparent from the scale of the business operations being conducted, which, for all the family companies, involved gross revenues exceeding $100,000,000 a year (A. 70).

The case presents, therefore, without any complicating circumstance, the simple issue whether a business expenditure by a corporate officer to aid him in fulfilling that role and earning his official compensation should be allowed as a business deduction or disallowed for the mere reason that the corporation also benefits, a fact that to most minds would afford the strongest corroboration for the authenticity of the business purpose. This question is of daily incidence in the administration of the tax law and should be resolved by this Court.

REASONS FOR GRANTING THE WRIT

1.

There Is a Conflict Between the Circuits on the Question in Issue

The Tax Court was led to its erroneous conclusion by a mistaken application of *Deputy* v. *DuPont*, 308 U. S. 488 (1940). There one taxpayer was held not entitled to deduct the expenses of another. The Tax Court misinterpreted this to require it, upon finding the expenditures to benefit the business of the corporation *as well as* the business of the taxpayer, to disallow them as deductions by the taxpayer.

This is in direct conflict with the landmark decision of Judge Learned Hand in *Schmidlapp* v. *Commissioner*, 96 F. 2d 680 (2nd Cir. 1938), which has stood unchallenged during all those years. There a vice president of the Chase Bank was permitted to deduct, as a business expense, the costs he incurred personally in entertaining out-of-town customers of the Bank. Obviously those expenditures were of benefit to the Bank as well as to the vice-president, as in the case at bar, since customers are necessary as well as employees. But on the very issue raised in this petition, the court held:

> "It is no answer to say that [the expenses] were for the bank's benefit; so were all the taxpayer's services; if it did in fact give him to understand that he was to extend a factitious hospitality in its interest, the cost of it was a necessary expense of his office."[3]

The *Schmidlapp* reasoning is in line with a number of other decisions by the Tax Court itself. In *Benjamin Abraham*, 9 T.C. 222 (1947), the court permitted "one of the chief executive officers" of the company to deduct the unreimbursed expenses of entertaining its customers. The Tax Court there pointed out that "he testified that in such capacity he felt it was good business policy to make the expenditures."[4] In *Harold A. Christensen*, 17 T.C. 1456 (1952), a field manager of Parke-Davis Company was allowed to deduct unreimbursed expenses of entertaining the salesmen whom he supervised and their families. He did so "in an effort to bring about and maintain good business relations between those salesmen and himself so that the business of his employer might prosper and his own earnings increase.

[3] 96 F. 2d 680, 682 (1938).

[4] 9 T. C. 222, 228 (1947).

He was not required by his employer to make those expenditures, but made them entirely on his own initiative. He and his predecessor had followed this practice for many years."[5]

The acceptance of the *Schmidlapp* ruling has been so widespread that in 1953 it was observed that "since *Schmidlapp*, no successful challenge has been made to the legitimacy of entertainment expenses of the executive of a publicly-held corporation as a category of deduction."[6] And in 1956, on facts almost identical with those of the instant case, the Federal District Court for the Western District of Kentucky held that the expenses were deductible by the officer as a business expense. In *Embry's Estate* v. *Gray*, 143 F. Supp. 603, 605 (W. D. Ky. 1956), the court said:

> "According to the testimony of Mrs. Embry, some eighteen or twenty persons were entertained at a Derby Breakfast in Louisville and one couple were house guests of the Embrys for the Derby weekend and this deduction is claimed as a business deduction by reason of the fact that they were executive officers or prospective customers of Mr. Embry's Company and that his salary was regarded by the Directors of the Company as being sufficient to allow him to entertain in this manner at his own and not the Company's expense.
>
> * * *
>
> ". . . the Court allows $400 as a business expense and the claimed deduction should not have been disallowed by the Commissioner. Cohan v. Commissioner, 2 Cir., 39 F. 2d 540, 543."

An appeal from this decision was dismissed on motion of the Director of Internal Revenue. *Gray* v. *Embry's Estate*, 244 F. 2d 718 (6 Cir. 1957).

---

[5] 17 T. C. 1456, 1456-1457 (1952).

[6] Note, *Deductibility of Expenses Incurred for the Benefit of Another*, 66 Harv. L. Rev. 1508, 1509 (1953).

The Court of Appeals for the Fourth Circuit in its decision below implicitly recognized the conflict between the position of the Tax Court and *Schmidlapp*. It attempted to distinguish the *Schmidlapp* case in several ways.

First, it cited that case for the proposition that only expenses "essential to the continuance of [the officer's] employment" were deductible as business expenses by the officer. It is, however, clear that Judge Hand's opinion intended no such requirement (For the convenience of the Court, the pertinent parts of the *Schmidlapp* opinion are printed at page 21 in the Appendix to this petition.). There was no showing in *Schmidlapp* that the entertainment was "essential to the continuance of his employment", and nothing in the opinion suggests that Judge Hand could have been persuaded to believe that a vice president of the Chase Bank would have been fired if he had not taken out-of-town visitors to the Recess Club. There was, however, evidence in *Schmidlapp*, as here, that the entertainment of the Bank's key customers—here the Company's own employees—was expected and customary and benefited both the officer and the Bank. It was also clear that it was Bank policy not to reimburse the officer for such expenses. This was held sufficient for the deduction in *Schmidlapp*. It was held insufficient here. The court below in effect declared that no unreimbursed expenditure can be allowed as a deduction unless the particular expenditure is specifically required by the board of directors and not even then if it is addressed basically to increasing the business of the corporation. *Schmidlapp* allows; the decision below disallows.

True enough, the Fourth Circuit had previously said, in considering a teacher's expenses in attending summer school, that deductible expenditures must be essential to the continuance of the taxpayer's employment. *Hill* v. *Commissioner*, 181 F. 2d 906 (4th Cir. 1950). But this, if meaning

what it was cited for below, merely emphasizes the determination of the Fourth Circuit to establish new doctrine despite the rule in other circuits. *Schmidlapp* had no such overtone and the court's attempt to distinguish it on this basis in its opinion below merely spotlights the resulting conflict.

In the third place, the court below cited as significant the lack of evidence that the expenditures had any direct and measurable effect on the amount of taxpayer's bonus for the years in question. This again points up the conflict with *Schmidlapp* where no such showing was thought necessary.

Finally, the court below emphasized that the taxpayer was more than an ordinary officer of the corporation. He was "the dominant officer and stockholder." But of course he is not the only stockholder. In fact there are many. This there could be no suggestion that the Company is a mere personal and formal arrangement. The reasoning is only that if, by exercise of all his resources, the President could presumably change Company policy, then a reasonable and usual business deduction, otherwise allowable, should be disallowed. This is a dubious rule indeed and one that can lead to endless confusion. Again it emphasizes the conflict with *Schmidlapp*, where the premise of decision was not compulsion beyond the powers of the officer to overcome, but business policy that is understandable and productive in eliciting the best teamwork from a group of men. The tax law, being essentially practical in nature, was intended to respect, rather than frustrate, these realities of the economic system on which it depends.

It is thus clear that the decision of the Court of Appeals for the Fourth Circuit below is in direct conflict with the leading decision of the Court of Appeals for the Second Circuit in *Schmidlapp* v. *Commissioner*, 96 F. 2d 680 (2d Cir. 1938), as well as with the decision of the District Court in *Embry's Estate* v. *Gray*, 143 F. Supp. 603 (W. D. Ky.

1956), *appeal dismissed*, 244 F. 2d 718 (6th Cir. 1957), and the Tax Court's position in *Harold A. Christensen*, 14 T.C. 1456 (1952).

2.

The Question Is of Importance to the Proper Administration of the Revenue Laws

Thousands of persons throughout the country are in the business of earning a living as officers of corporations large and small. Because of their jobs many of them are expected to incur expenses that are not reimbursed by the corporation. Not only is this a reality of the business world, but in addition it is socially desirable as one of the few remaining areas of individual initiative and accountability. Many of these expenses have been long recognized, particularly since the *Schmidlapp* decision in 1938, to be deductible under §23(a)(1)(A) as business expenses. Clearly a substantial number of these persons are officers in top management positions or have substantial stockholdings. They are thus in a position, if the matter were put to a test, to compel or to induce the corporation to reverse its policy or to make a preferential exception specially in their behalf and thus to reimburse them for these expenses.

If the decision below is allowed to stand, the treatment of tax deductions will depend not on the nature and effect of the expenditures, but on the scope of personal and corporate influence that the taxpayer might exert. This turns the law away from the productive purpose for allowing the deduction in the first place, which is to encourage expenditures that tend to increase the ultimate earnings upon which the income tax is dependent. Adhering to that purpose permits the development of standards that are sufficiently uniform to be understandable and usable in the adminis-

tration of the tax law. But abandoning it, as the court below requires, will lead only to different results for the same expenditures by different people depending on their respective degrees of influence. This will invite confusions of a nature to obstruct the understanding and administration of the law.

The question is of such general importance in collecting the revenues of the Government that it should be settled by this Court. It is important also in the further sense that the philosophy of individual incentive has been a cardinal principle of our economic system, as it has in the growth of this particular company. If that principle is to be denied its proper recognition in the tax laws, a disservice will be done to American business, first by handicapping character and eventually by retarding revenue.

CONCLUSION

There is a clear conflict between the Court of Appeals for the Fourth Circuit below and the Court of Appeals for the Second Circuit, as well as with a District Court within the Sixth Circuit. Until this conflict is resolved, uncertainty as to the deductibility of many normal business expenses will continue to exist. The point affects so many people throughout the nation and is of such importance in the practical administration of the revenue laws that it should be settled by this Court.

The writ of certiorari should be granted.

Respectfully submitted,

Dated: September 4, 1959

GEORGE D. GIBSON
H. BRICE GRAVES
GEORGE C. FREEMAN, JR.
Counsel for Petitioners

HUNTON, WILLIAMS, GAY,
MOORE & POWELL
1003 Electric Building
Richmond 12, Virginia
Of Counsel